**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

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|---|---|---|---|---|---|
| Author: | Wyland | Analyst: | Jeff Garnier | Bill Number: | AB 1488 |
| Related Bills: | None | Telephone: | 845-5322 | Introduced Date: | Feb. 22, 2005 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Exclusion of Gain on the Sale of Certain Capital Assets

## SUMMARY

This bill would exclude capital gains from the sale of certain assets held at least one-year that are purchased after 2005 and sold before 2011.

## PURPOSE OF THE BILL

The author's office has indicted that the purpose of the bill is to encourage new investment within the state.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and operative for taxable years beginning on or after January 1, 2006, and before January 1, 2011.

## POSITION

Pending.

## SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation and policy concerns discussed in this analysis.

## ANALYSIS

### FEDERAL/STATE LAW

Under federal and state law, capital assets are defined as assets held that are not:

1. Inventories,
2. Properties used in an active trade or business subject to depreciation or real property used in a trade or business,
3. Accounts or notes receivable,
4. Supplies, regularly consumed by the taxpayer in the ordinary course of the taxpayer's business,
5. Copyrights or other similar property,
6. Certain publications of the United States Government,
7. Any commodities derivatives held by a commodities dealer, and
8. Certain hedging transactions.

| Board Position: | | | Department Director | Date |
|---|---|---|---|---|
| ____ S | ____ NA | ____ NP | | |
| ____ SA | ____ O | ____ NAR | Gerald H. Goldberg | 5/6/05 |
| ____ N | ____ OUA | X PENDING | | |

Prior to 1987, under federal law and the California Personal Income Tax Law (PITL), part of the gain from the disposition of a capital asset was excluded from income. Beginning in 1987, under federal law and the PITL, 100% of gain from the disposition of capital asset was taxed at the same rate as ordinary income. In 1996, the federal law was changed to reduce the tax rates on capital gains. California continues to tax capital gains at the ordinary tax rate under the PITL. Capital gains have always been taxed at the ordinary income tax rate under the California Corporation Tax Law (CTL).

Under federal and state law, gains and losses from capital assets are treated differently than ordinary income transactions. Capital gains and losses are netted against each other. If the netting results in a net gain, the appropriate amount of tax is paid on the net gain. For individuals, if the netting results in a net loss, up to $3,000 per year may be deducted against ordinary income. Any amount in excess of $3,000 is carried over to succeeding years. Corporate taxpayers are prohibited from using any capital losses to offset ordinary income.

Part of the gain from assets used in a trade or business, referred to as Section 1231 assets, may qualify for capital gain treatment. Most Section 1231 assets may be depreciated or amortized. Any gain from the disposition of Section 1231 assets in excess of any depreciation or amortization previously deducted is given capital gain treatment. This allows the “1231” gain to be netted against other capital gain or loss transactions. Under federal law the “1231” gain is taxed at the lower capital gain tax rates.

Federal and state law provide for preferential treatment of certain small business corporation stock. The rules vary depending on the type of stock and whether the taxpayer is corporate, non-corporate, or an individual. Generally, small business stock rules require the taxpayer to be the original owner of the stock and permit:

- Ordinary losses rather than capital losses,
- Rollover of gains, or
- Exclusion of part of the gain.

<u>THIS BILL</u>

This bill would exclude from income any gain on the sale of a “new equity investment” purchased on or after January 1, 2006, and before January 1, 2011, and held for more than one year. A “new equity investment” is defined as any new purchase of an interest in or the assets of a sole proprietorship, partnership, or corporation whose principal activities are located in this state. The property purchased must qualify as a capital asset.

<u>IMPLEMENTATION CONSIDERATIONS</u>

The phrase “principal activities are located in this state” is not defined. The absence of a definition clarifying this phrase could lead to disputes with taxpayers and would complicate the administration of this exclusion.

**OTHER STATES’ INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These states were selected due to their similarities to California’s economy, business entity types, and tax laws.

Research did not indicate that *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* laws provide a capital gain exclusion comparable to the exclusion allowed by this bill.

Until 2001, *Massachusetts* had a reduced tax rate for capital gains. Presently capital gains are taxed at the ordinary income tax rates.

**FISCAL IMPACT**

This bill would not significantly impact the department's costs.

**ECONOMIC IMPACT**

Revenue Estimate

This bill would allow an exclusion of capital gains for the sale of assets that qualifies as a new equity investment purchased after 1/1/2006 and before 1/1/11 and is held for more than one year.

Based on historical trends and the discussion below, the revenue loss from this bill is as follows:

| **Estimated Revenue Impact of AB 1488**<br>Effective Tax Years BOA 1/1/2006<br>Assumed Enactment Date After 6/30/05<br>**(Millions)** | | |
|---|---|---|
| **2006-07** | **2007-08** | **2008-09** |
| -$100 | -$700 | -$1,000 |

Revenue Discussion

This analysis does not consider the possible changes in investment activity, employment, personal income, or gross state product that could result from this measure.

The revenue impact of this bill is dependent on the amount of equity investments entered into after 1/1/2006 and held for one year or longer.

Based on the department's 2002 capital gain sample, the percentage of total capital gains from the sale of property purchased after January 1, 2006, and held for more than one year is estimated to be 18% in 2007, 29% in 2008, and continues to increase annually thereafter. Total capital gains were extrapolated into the future assuming a fixed annual growth rate of 5%. For calendar year 2007, it is estimated that total capital gain tax will approximate $3.5 billion under the PITL and $.4 billion under the CTL. Limiting total combined taxable gains to 18%, a decrease in revenues is estimated to approximate $700 million ($3.5 billion + $.4 billion) x 18%).

**LEGAL IMPACT**

This bill would require the principal activities of the business invested in to be located in this state. This requirement may be unconstitutional as it could violate the federal commerce clause.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is apparently seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

**LEGISLATIVE STAFF CONTACT**

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